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No. 983

IN THE

Supreme Court of the United States

OCTOBER TERM, 1963

CHICAGO NORTH SHORE AND MILWAUKEE RAILWAY COMPANY, *Petitioner,*

v.

UNITED STATES OF AMERICA, *Respondent.*

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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IN THE

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CHICAGO NORTH SHORE AND MILWAUKEE RAILWAY COMPANY, *Petitioner,*

v.

UNITED STATES OF AMERICA, *Respondent.*

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Chicago North Shore and Milwaukee Railway Company petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit in the above cause.

OPINIONS BELOW

The unreported opinion of the United States District Court for the Northern District of Illinois, Eastern Division, is set forth at page 2 of the Appendix to Appellants Brief (in the Court of Appeals) filed herewith.

The opinion of the Court of Appeals, 326 F. 2d 860, is set forth at the close of this petition.

JURISDICTION

The judgment sought to be reviewed is dated and was entered January 16, 1964. The jurisdiction of this Court is invoked under sections 1254(1) and 2101(c) of Title 28, U.S.C.

QUESTIONS PRESENTED

1. In 1944 the holders of taxpayer's defaulted promissory notes sold the taxpayer's coupon bonds which they held as collateral security for said notes. The parties to this suit stipulated that "the amount of interest on the collateral bonds sold in 1944 . . . computed from January 1, 1944 to the respective dates of sale thereof . . . amounted to $81,393.82." The trial court adopted the stipulated facts as its findings of fact.

The question presented is whether an accrual basis taxpayer may deduct the aforesaid interest which accrued unconditionally in 1944 or whether as held by the courts below the amount of said interest constitutes bond discount and must be amortized.

2. In 1932 the taxpayer deposited its own mortgage bonds as collateral security for the payment of four promissory notes issued by it in 1932 to Reconstruction Finance Corporation and three Chicago banks. Semi-annual interest coupons maturing subsequent to June 30, 1932, were attached to the bonds. After default on the notes, the bonds were sold in 1944. Upon the sale, matured interest coupons in the amount of $2,295,205.07 became due and payable forthwith. This figure is the aggregate of the obligation evidenced by interest coupons maturing prior to January 1, 1944, in the amount of $2,213,811.25 and interest from January 1, 1944 to

the respective dates of the bond sales in 1944 in the amount of $81,393.82.

The question presented is whether under the accrual basis of accounting the $2,295,205.07 obligation is deductible in 1944 when it became due and payable unconditionally, or whether, as held by the courts below, such amount must be amortized and deducted ratably over the period intervening to the date in 1956 upon which the principal amount of part of the bonds became due according to their original tenor.

3. Subsequent to the sale of the collateral bonds in 1944, and for the year 1945 and the ten months period ending October 31, 1946, the taxpayer deducted interest accrued upon its three remaining outstanding promissory notes. The claims of the holders of these notes were subordinated in a Chapter X Bankruptcy proceeding and there was little likelihood that the notes or the interest thereon would be paid.

The question presented is whether an accrual basis taxpayer may deduct the interest which accrued on the notes subsequent to the sale of the collateral security for the notes.

4. Pursuant to a Chapter X Bankruptcy reorganization a new corporation was formed and on November 1, 1946, all of the old debtor corporation's assets, including the real property which constituted the security for the old corporation's bonded indebtedness, were transferred to the new corporation. The new corporation assumed the obligation to pay any income tax liability of the old corporation and it assumed the obligation to satisfy the old mortgage bond obligation by the payment of cash and the issuance of its own capital stock. It assumed no other obligations or debts of the

old corporation. The old corporation was liquidated and dissolved.

The question presented is whether upon the transfer of the mortgage property to the new corporation in 1946 and the complete liquidation and dissolution of the old corporation, the latter may deduct its unamortized bond discount.

5. In 1932 the taxpayer deposited its own coupon bonds as security for the payment of its four promissory notes. In 1944 after default on the notes, the noteholders sold the collateral bonds. The principal obligation of the bonds, together with the obligation evidence by matured interest coupons exceeded their proceeds by $4,185,029.07.

The question presented is whether the $4,185,029.07 may be deducted as a cost or an expense or a loss when it accrued unconditionally in 1944, or whether, as held by the courts below, this amount must be treated as bond discount and amortized and deducted ratably over the period intervening to the dates in ~~1955 and~~ 1956 upon which the principal amount of the bonds became due according to their original tenor.

STATUTORY PROVISIONS

INTERNAL REVENUE CODE OF 1939, TITLE 26, U.S.C.

"SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) Expenses.—

(1) Trade or Business Expenses.—

(A) In general.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade

or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *

* * * * * * *

(b) Interest.—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.

* * * * * * *

(f) Losses by Corporations.—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise."

STATEMENT

This is a suit for refund of income taxes for the year 1945. Because of a loss carrover from 1944 and a loss carryback from 1946, those two years also are involved. No question as to the right to such carryover or carryback is raised, the only question with respect thereto being the amounts thereof.

The taxpayer's accounts were kept, and its tax returns were filed on the accrual basis.

In 1932, in the normal course of a funding operation, the taxpayer issued its four promissory notes, due April 1, 1935, to Reconstruction Finance Corporation and three Chicago banks. It deposited its own mortgage bonds, with all semi-annual interest coupons dated subsequent to June 30, 1932, attached, as collateral security for the promissory notes. One bank assigned its note to the Reconstruction Finance Corporation,

together with the collateral security deposited in connection therewith.

Subsequently, in 1932, a receivership proceeding was commenced in the United States District Court at Chicago, other proceedings were filed and in 1942 all prior proceedings were consolidated into a Chapter X Bankruptcy proceeding filed in 1942. The four promissory notes were not paid when due and remained in default. Pursuant to authority granted by the Court, the Reconstruction Finance Corporation and one other noteholder, at various times in 1944, sold the collateral bonds held as security. The remaining noteholder sold part of its collateral and took title to the balance in payment of the remaining note liability owed to it.

The bonds contained a provision accelerating their maturity upon the occurrence of certain events of default. When the bonds were sold the events of default had occurred and, accordingly, the bonds were due and payable when they were sold by the note holders.

In its income tax return for the year 1944, the taxpayer deducted the net result of the foregoing transactions as a loss, resulting in a net operating loss carryover to the year 1945.

In 1946, pursuant to a plan of reorganization, a new corporation was formed and on November 1, 1946, all of the old corporation's assets, including the real property which constituted the security for the mortgage bonds, were transferred to the new corporation and the old corporation was dissolved. The new corporation agreed to pay any federal income taxes that might be due from the old corporation, and it satisfied the old corporation's bonded indebtedness by the payment

of cash and the issuance of its own capital stock to the bondholders.

The Commissioner of Internal Revenue disallowed a portion of the 1944 loss claimed upon the old corporation's return (thus reducing the 1944 loss carryover) and assessed a deficiency in tax for the year 1945 against the new corporation as *transferee*. The latter paid the tax and interest thereon, duly filed a claim for refund which was denied, and brought suit for refund as provided by Sections 1346 of Title 28 and 7422, Title 26, U.S.C. The trial court adopted the stipulation of facts as its findings of fact and entered judgment for the defendant. The Court of Appeals affirmed.

The trial court's opinion and judgment and the stipulation of facts are set forth in the printed Appellant's Appendix filed in the Court of Appeals, a copy of which is attached hereto.

REASONS FOR GRANTING THE WRIT

I.

The Court of Appeals Decision, Denying a Deduction of $81,392.82 as Interest for the Year 1944 is in Conflict With a Decision of This Court and With Decisions of the Third and Ninth Circuits.

The court's ruling with respect to an item of $81,393.82 is in conflict with a decision of the Supreme Court and several Court of Appeals decisions.

On page 9a of its opinion the Court of Appeals held that "the $2,295,205.07 which the Railway seeks to deduct as interest is not interest *in fact*." This determination was made notwithstanding that the parties stipulated that $81,392.82 thereof was interest (pars. 14 and 15, Stipulation of Facts, C.C.A. Appen-

dix 28-29), and the trial court adopted the stipulated facts as its finding of facts. The $2,295,205.07 consisted in part of $2,213,811.25 evidenced by collateral bond interest coupons maturing *prior* to January 1, 1944. The remaining $81,392.82 represented "interest computed from January 1, 1944 to the respective dates of sale thereof . . ." in 1944.

In disallowing the entire amount as a current deduction, the courts below disallowed the $81,393.82 interest included therein which accrued for that portion of the year 1944 prior to the sale of the collateral bonds. The Court of Appeals held (opinion p. 9a) that inasmuch as there was no indebtedness on the collateral bonds prior to their sale, no interest with respect thereto could be accrued and deducted for any period prior to such sale.

The same reasoning and conclusion were rejected in the following cases, and the decision of the Court of Appeals in the present case is in conflict therewith.

Commissioner v. *Philadelphia Transportation Company*, (1949), 338 U.S. 883, 70 S. Ct. 186, affirming per curiam, 3 Cir., 174 F. 2d 255 and 9 T.C. 1018.

Pressed Steel Car Co., Inc. v. *Commissioner*, 3 T.C.M. 868, 876-877, aff'd. per curiam, 3 Cir. 1945, 152 F. 2d 280, cert. den. 328 U.S. 838, 66 S. Ct. 1013.

Commissioner v. *Columbia River Paper Mills*, 9 Cir. 1942, 126 F. 2d 1009.

See also, *Oregon Pulp & Paper Co.* v. *Commissioner*, 1942, 47 B.T.A. 772, 779, appeal by Commissioner dismissed, 9 Cir. Nov. 2, 1943.

The Court of Appeals, in holding that there can be no interest deduction allowed with respect to any period

prior to the dates the bonds were sold, applied the rule of *Commissioner* v. *Drovers Journal Publishing Co.*, 7 Cir. 1943, 135 F. 2d 276, 279 but without citing the latter case. The latter was in conflict with *Commissioner* v. *Columbia River Paper Mills, supra*, a Ninth Circuit case decided in 1942. It was also in conflict with *Pressed Steel Car Co.* v. *Commissioner, supra*, a Third Circuit case decided in 1945. The denial of certiorari in the latter case failed to resolve the conflict. By granting certiorari and affirming the Third Circuit in 1949 in *Philadelphia Transportation Co.*, the Supreme Court resolved the conflict *against* the rule of the Seventh Circuit in *Drover's Journal Publishing Co.* Nevertheless, in the present case the Court of Appeals follows the basic reasoning and result of its own Circuit in the *Drovers Journal* case and ignores *Philadelphia Transportation Co.* and the other conflicting Court of Appeals decisions cited above.

In the *Philadelphia Transportation* case, *supra*, the courts allowed, in the year of issuance of the bonds, a deduction for accrued interest in an amount equal to the aggregate of all matured interest coupons attached at the date of sale. In that case when the bonds were sold there were attached thereto coupons which matured not only in the taxable year of sale but also in the prior taxable year. Similar treatment in the instant case would allow an interest deduction in 1944 in an amount not less than the $81,393.82 interest item which was stipulated to be interest, and would also allow an interest deduction for the year 1944 of approximately $189,119 evidenced by the 1943 interest coupons which accrued unconditionally upon the sale of the bonds in 1944.

The treatment accorded this taxpayer is in conflict with each of the cases cited above. It is also in conflict with the "all events" test reaffirmed in *United States* v. *Consolidated Edison Co.*, 1961, 366 U.S. 380, 384, 81 S. Ct. 1326, 1329. That case requires an accrual basis taxpayer to take deductions in the year, and only in the year, in which the obligation unconditionally accrues.

The Court of Appeals avoided any reference in its opinion to the $81,393.82 interest item which was emphasized on brief and oral argument. The fact that the item was ignored by the Courts below, ought not serve as a cloak to avoid the granting of the Writ.

II.

The Holding of the Court Below That An Item of $2,295,205.07 Must be Treated as Bond Discount and Amortized Over a Period Beyond Its Due Date to the Maturity of the Principal Amount of the Bonds is in Conflict With Applicable Decisions of This Court.

The Court of Appeals held that the $2,295,205.07 evidenced by the prior dated interest coupons which accrued unconditionally upon the sale of the bonds in 1944 was bond discount and should be amortized ratably over the intervening period to April 1, 1956, the date upon which the principal amount of part of the collateral bonds, namely the Series B and C bonds, became due according to their original tenor. (Opinion p. 40a, and C.C.A. Appendix p. 4)

Bond discount is the excess of the principal amount of the debt *which is to be paid at the maturity of the bonds* over the proceeds received from the lender at the time of the creation of the debt.

New York C. & S. & L. R. Co., 1931, 23 B.T.A. 177, 196.

Helvering v. *Union Pacific R. Co.*, 1934, 293 U.S. 282, 284, 286, 55. S. Ct. 165, 166, 167, 168.

Dodge Brothers v. *United States*, 4 Cir. 1941, 118 F. 2d 95, 103.

Pierce Oil Corp. v. *Commissioner*, 1935, 32 B.T.A. 403, 420, 421.

The $2,295,205.07 involved in this issue does not fall within the definition of bond discount. It is *not* an amount which is to be paid at the maturity of the bonds in 1955 and 1956. In *Helvering* v. *Union Pacific R. Co., supra*, the court said (pp. 284 and 166):

> "It follows that when the return is made on the accrual basis, expenses or obligations incurred by the taxpayer in connection with a bond issue, *which are not discharged until payment of the bonds at maturity*, may properly be accrued or amortized over the period of the life of the bonds * * *." (Italics added).

And at pages 277 and 168, the Court refers to "the difference between the net amount of capital realized upon issue and the par value of the bonds" which must be paid to the bondholders at a fixed date, namely, the due date of the bonds. The court held that the commissions there in issue were, in substance, the same as bond discount because, and only because, like bond discount, they reduced the proceeds to the borrower and were to be paid at the *maturity of the principal amount of the bonds.*

For illustration, according to their original tenor, the Series A bonds herein involved matured January 1, 1955, and the Series B and C bonds matured April 1, 1956. Could the Court of Appeals, by judicial fiat, declare that any bond discount attributable to the

Series A bonds must be amortized, not to their own maturity date, but to April 1, 1956, the maturity date of the Series B and C obligations? Yet that is precisely what it did with respect to the $2,295,205.07 obligation when it required that this amount be amortized to April 1, 1956.

Bond discount is an amount which is due and payable at the maturity date of the face amount of the bonds. Such maturity date marks the end of the intervening period over which the discount must be prorated. The $2,295,205.07 obligation here in issue accrued unconditionally in 1944. It matured and became due and payable forthwith upon the sale of the collateral bonds in 1944. That date marked the end of any possible amortization period with respect to any bond discount feature attributable to the $2,295,205.07 obligation. There is no future maturity or due date to which it can be amortized. *There is no statutory provision, no regulation, and so far as we are aware no court decision, other than the present one, which requires the amortization of bond discount beyond the date when such discount obligation matures and becomes due and payable.*

The $2,295,205.07 in issue cannot be classified as bond discount, and, regardless of its classification, there is no authority for its amortization over a period subsequent to its due date.

The bond discount rule is an exception to the general rule of income tax accrual. The general rule, reaffirmed by this Court in *United States* v. *Consolidated Edison Co.*, 1961, 366 U.S. 380, 384-385, 81 S. Ct. 1326, 1329, requires that an item which accrues unconditionally must be deducted in the year of accrual and in no other year.

The decision of the court below is in conflict with *Helvering* v. *Union Pacific R. Co.*, *supra*, in that (1) it requires amortization as bond discount of an amount which is not bond discount, and (2) it requires amortization of such amount beyond its maturity or due date to a future date when it is neither due or payable.

The decision is also in conflict with *United States* v. *Consolidated Edison Co.*, *supra*, in that it fails to allow the deduction in the year when it accrued unconditionally.

III.

The Holding of the Trial Court Affirmed by the Court of Appeals Disallowing Deduction of Interest Accrued on the Taxpayer's Outstanding Promissory Notes is in Conflict With Decisions of Two Other Circuits.

When the collateral bonds were sold in 1944 one of the collateral notes was satisfied and the other three notes continued as outstanding obligations. The taxpayer deducted the interest accrued on these three notes for the years 1944, 1945 and the 10 months period ending November 1, 1946. In determining the deficiency here in issue, the Commissioner allowed the deductions. As an affirmative defense, although not pleaded, the Government contended that no interest was accruable or deductible on such notes subsequent to the sale of the collateral. The District Court held that such interest should be disallowed as a deduction "there being no fixed and definite obligation to pay interest thereon after the sale of the bonds in 1944" (C.C.A. Appendix p. 5).

The Court of Appeals did not refer to this issue in its opinion, but in affirming the District Court it sanctioned that Court's holding.

The holding is in direct conflict with the decisions in the following cases:

Fahs v. *Martin*, 5 Cir. 1955, 224 F. ed. 387, 392-393, 395;

Zimmerman Steel Co. v. *Commissioner*, 8 Cir., 1942, 130 F. 2d 1011, 1012;

Keebey's Inc. v. *Paschal*, 8 Cir., 1951, 188 F. 2d 113, 115. See also I. T. 3635, 1944 C.B. p. 101.

This issue involves an important question of federal income tax law, namely, whether an accrual basis taxpayer may be deprived of deductions which unconditionally accrue merely because, due to his financial condition or due to his involvement in Bankruptcy or receivership proceedings, there is a likelihood that such accrued obligation will not be paid. In other words, must a financially embarrassed accrual basis taxpayer be denied deductions to which he would otherwise lawfully be entitled. This is a question of exceedingly broad and important impact which should be decided by this Court.

Nor should the foregoing conflict of Circuits remain unresolved.

* * * * * * *

Subsequent to the time the foregoing was written this Court on March 23, 1964, decided *Bruning* v. *United States*, No. 423, U.S. . The opinion, together with note 4 thereof, states (1) that the filing of a petition in bankruptcy does not prevent the running of interest during the bankruptcy proceeding, and (2) that the rule denying post petition interest as a claim against the bankruptcy estate is applied "not because the claims had lost their interest bearing quality during that period, but as a necessary and enforced rule of distribution * * *".

The decision of the trial court in the present case that there was "no fixed and definite legal obligation to pay interest thereon after the sale of the (collateral) bonds in 1944" (C.C.A. Appendix p. 5), which holding was affirmed by the Court of Appeals, is in conflict with *Bruning* v. *United States, supra*, and the cases cited in note 4 of that opinion, as well as the Fifth and Eighth Circuit cases cited above.

IV.

The Court's Holding That, Upon the Transfer of the Mortgaged Property and the Complete Liquidation and Dissolution of the Taxpayer, It Could Not Deduct Its Unamortized Bond Discount is in Conflict With Decisions of This Court and of a Court of Appeals.

On November 1, 1946, the actual effective date of the plan of reorganization under Chapter X of the Bankruptcy Act, the taxpayer transferred to a new corporation all of the property and assets of the old corporation, in consideration of the assumption by the new corporation of certain liabilities of the old corporation including ". . . any claim of the United States against the Debtor for taxes . . ." and the bonded indebtedness of the old corporation. The old corporation was then dissolved. Included among the assets transferred was the real property which constituted the security for the taxpayer's mortgage bonds. The new corporation satisfied the bond obligation in full by the payment of cash and the issuance of its own common stock. The Court of Appeals held that the old corporation could not upon liquidation and dissolution deduct its unamortized bond discount because:

1. The new corporation was merely a continuation of the old corporation, and

2. Viewing the two corporations as separate entities, the new corporation may not take the deduction because the deduction is available only to the old corporation.*

(1) The new corporation did not become liable for all of the old corporation's liabilities. The two corporations had different shareholders and different corporate structures. They filed separate income tax returns. The tax liability of the old corporation was imposed against the new corporation as *transferee* because it had specifically *assumed* that liability.

As pointed out in *Donohue* v. *United States*, 1953, 112 F. Supp. 660, 663, the new corporation, following a railroad reorganization, is a different corporation and a different taxpayer from the old corporation and the "ruling of the Supreme Court in *New Colonial Ice Co.* v. *Helvering*, 292 U.S. 435" is controlling.

The old corporation and the new corporation were separate and distinct taxable entities.

New Colonial Ice Co. v. *Helvering*, 1934, 292 U.S. 435, 54 S. Ct. 788.

Standard Paving Co. v. *Commissioner*, 10 Cir. 1951, 190 F. 2d 330, cert. den. 342 U.S. 860, 72 S. Ct. 87.

Cf. *Moline Properties* v. *Commissioner*, 1943 319 U.S. 436, 63 S. Ct. 1132.

The holding of the Court below that the new corporation "is substantially the same as the old corporation" is in conflict with *New Colonial Ice Co.* v. *Helvering*, *supra*.

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* The court's reasoning (see pp. 11a-12a of opinion) is not clear. The court would appear to have forgotten that it was determining the tax liability of a *transferee*.

(2) Its holding is in conflict with *United States* v. *Memorial Corporation*; 6 Cir. 1957, 244 F. 2d 641, 644, which held that upon its liquidation and dissolution, the taxpayer was entitled to the deduction of its unamortized bond discount.

Its holding also is in conflict with the following decisions:

Longview Hilton Hotel Co. v. *Commissioner*, 1947, 9 T.C. 180, 182, "Acq." C.B. 1947-2 at p. 3, which held that upon liquidation and dissolution, the unamortized mortgage discount was deductible by the taxpayer;

S. & L. Building Corp. v. *Commissioner*, 1930, 19 B.T.A. 788, 795, Acq. C.B. X-1, p. 60, (cited in note 3 of Helvering v. Union Pacific R. Co., 293 U.S. 282) which held that where the mortgaged property was sold and the purchaser assumed the mortgage obligation, the unamortized mortgage discount was allowable as a deduction in the year of sale; and,

Metropolitan Properties Corp. v. *Commissioner*, 1931, 24 B.T.A. 220, 225, Government appeal dismissed 5 Cir. Feb. 21, 1933, Acq. CB XI-1, p. 5, which held that where the mortgaged property was sold subject to the mortgage, the unamortized bond discount should be allowed as a deduction.

In *Anover Realty Corp.* v. *Commissioner*, 1960, 33 T.C. 671, 674, the Tax Court held that upon transfer of the mortgaged property in dissolution, the unamortized mortgage discount deduction was not available to the transferee corporation but was available only to the transferor corporation.

The Court of Appeals cites *Anover Realty Corp.* v. *Commissioner*, *supra*, (see p. 12a of opinion) in support of its holding. Yet this case is wholly consistent

with the other decisions cited above and tends to support the taxpayer's position rather than that of the Government. The Court says that the theory of the taxpayer is "dichotomous," but the dichotomy is in the opinion of the Court of Appeals and is attributable to Court's failure to deal with the question in the light of the fact that the taxpayer is a *transferee*.

In the present case the mortgaged property was transferred to the new corporation free and clear of the mortgage lien, but the new corporation assumed the mortgage bond liability and discharged it in full by the payment of $3,500,000 cash and the issuance of its own capital stock.

By "acquiescing" in the foregoing Tax Court decisions and publishing such acceptance in the official Internal Revenue Cumulative Bulletins cited above, the Commissioner not only acknowledged the correctness of the rule therein stated but also eliminated any possibility of an appeal to a Court of Appeals.

We respectfully suggest that the conflict with *New Colonial Ice Co.* v. *Helvering*, *supra*, and the conflict of the present case with the *Memorial Corporation* case, *supra*; and with the cited Tax Court cases dating back over a period of 34 years, and which have been accepted as correct by the Commissioner, are of sufficient importance to warrant the attention of this Court.

V.

The Holding of the Courts Below That the Sale of the Collateral Bonds in 1944 Must Be Treated as a Separate Transaction is in Conflict With the Rule Followed By Several Circuits That An Integrated Transaction May Not Be Broken Down Into Its Several Steps and the Tax Consequences of the Last Step Determined Independently of the Whole.

The final question presented, and the most important one as far as the petitioner is concerned, is whether the sale of the collateral bonds in 1944 must be isolated from the transaction of which it was a part and treated as the issuance of bonds at a discount.

The answer to that question depends upon whether an integrated business transaction may be broken down into its various steps (i.e. the borrowing of money in 1932; the deposit of collateral bonds as security, and after default, the sale of the collateral security in 1944), and the tax consequences of the last step determined independently of the transaction as a whole.

The financial detriment which accrued unconditionally upon the sale of the collateral bonds in 1944 must be regarded as a cost or expense or loss proximately related to and growing out of the 1932 borrowing transaction. Any other view is not in accord with reality. In the instant case, the bond discount amortization rule is inapplicable, and the general rule, i.e. the "all events" rule reaffirmed in *United States v. Consolidated Edison Co.*, 1961, 366 U.S. 380 384, 81 S. Ct. 1326, 1329, requires the deduction thereof in 1944 when it unconditionally accrued.

To isolate the last step, namely, the sale of the bonds, and to treat such sale as separate corporate financing arrangement is unreal. No company would voluntarily

issue $5,601,811.25 of its own obligations for a net amount of $1,498,176 under conditions such that *the entire sum was due and payable forthwith* (see pp. 29 and 35 of C.C.A. Appendix. See also Section 10 of Def. Exhibit 8, at p. 149).

The substance of the transaction was a sale by the lender, of collateral security and not the issuance by the maker of bonds at a discount. It is only by separating the 1932 borrowing transaction into its various steps that the last step could be treated as an issue of bonds at a discount.

The substance of an integrated transaction and the tax consequences thereof must be determined with reference to the entire transaction and not by "atomizing" or separating the several steps and determining the tax consequences of a single step independently of the whole.

Commissioner v. *Bagley & Sewall Co.*, 2 Cir. 1955, 221 F. 2d 944, 946

Commissioner v. *Ashland Oil & Refining Co.*, 6 Cir. 1938, 99 F. 2d 588, 591, 592, cert. den. 306 U.S. 661

Kimbell-Diamond Milling Co. v. *Commissioner*, 14 T.C. 74, 80, affd. per curiam, 5 Cir. 1951, 187 F. 2d 718, cert. den. 342 U.S. 827

Hirsch v. *Commissioner*, 7 Cir. 1940, 115 F. 2d 656, 658.

The decision of the Court below is in conflict with the rational of each of the above cited decisions.

The conclusion that the entire loss accrued immediately upon the sale of the collateral in 1944 is inescapable. The bonds contained, *inter alia*, the following language: "*In case . . . any order of adjudication in bankruptcy against the Company, or upon the appointment of a receiver or receivers for the Company or the trust estate, or any part thereof, in any proceed-*

ing not brought by the Trustees, the principal of all bonds hereby secured, if not previously due, shall thereupon become due and payable, anything in said bonds or in this Mortgage to the contrary notwithstanding." (see paragraph XVI of Complaint, C.C.A. Appendix p. 13. See also Def. Exhibit 8, Sec. 10 at p. 149).

As early as September 30, 1932, a creditor's bill in equity was filed in the United States District Court for the Northern District of Illinois, Eastern Division, by American Brake Shoe and Foundry Company on behalf of itself and other creditors. Moreover, on December 16, 1937, the City National Bank and Trust Company of Chicago and Arthur T. Leonard as successor Trustees filed their bill to foreclose the first and refunding mortgage (see p. 5, Exhibit C, Trustees' Report and paragraph 1 of Stipulation of Facts, C.C.A. Appendix, p. 21).

Thus, within the same year as occurred the 1932 borrowing transaction, the bonds deposited as collateral to secure this borrowing became due and payable by virtue of the acceleration provision and the filing of the creditor's bill. Accordingly, in 1944, when these bonds were sold by the holders of notes, the purchasers of these bonds took an instrument which was, according to its tenor, payable forthwith. In other words, the purchasers took a *demand instrument*.

Even if it can be said that the sale of the collateral bonds by the lenders is a separate transaction and, in determining its Federal tax consequences, it must be isolated from the 1932 borrowing transaction of which it formed a part and that the excess of the maturity value of the bonds over their proceeds and the aggregate of the matured interest coupons represented "bond discount", there is no period over which the discount may be amortized. The coupons were due

and payable *and the principal amount of the bonds were then due and payable.*

To require that this amount be amortized over the period intervening from the date of the sale of the bonds to the dates in 1955 and 1956 upon which they became due according to their original tenor, would be, to use the words of the Court of Appeals, "to ignore practical realities."

The sale of the collateral bonds in 1944 directly and proximately resulted from a normal business transaction entered into in 1932 for the purpose of corporate business financing. Whether the resulting financial detriment be characterized as a loss or as an ordinary and necessary business expense or in part as interest is immaterial. It was one or the other. The deduction is allowable when it accrued unconditionally in 1944.

The decision of the courts below is in conflict with the "all events" test of accrual reaffirmed in *United States* v. *Consolidated Edison Co., supra.*

CONCLUSION

All of the foregoing issues arise out of the same transaction, namely, the sale of the collateral bonds in 1944. They involve tax accounting principles of importance to all accrual basis taxpayers. The decision of the court below is in conflict with the decisions of this Court and the Courts of Appeals cited above. These conflicts should be resolved. The petition should be granted.

Respectfully submitted.

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APPENDIX TO PETITION

IN THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

September Term and Session, 1963

No. 14178

CHICAGO NORTH SHORE AND MILWAUKEE RAILWAY COMPANY,
Appellant,

v.

UNITED STATES OF AMERICA, *Appellee.*

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.

January 16, 1964

Before DUFFY, KNOCH, and SWYGERT, *Circuit Judges.*

SWYGERT, *Circuit Judge.* The Chicago North Shore and Milwaukee Railway Company brought this action for a refund of federal income taxes for the year 1945 in the amount of $198,276.93, plus interest. The district court denied the refund. Plaintiff (identified as the Railway) is the successor in interest to the Chicago North Shore and Milwaukee Railroad Company (identified as the Railroad). The facts were stipulated.

The Railroad operated an electric interurban railroad between Chicago and Milwaukee. It was organized in 1924. It had to refinance its operations in 1932. In June of that year, the Railroad issued four collateral promissory notes

due April 1, 1935, and bearing interest at 6% per annum, as follows:

To: Reconstruction Finance Corporation its note dated June 10, 1932, for $1,150,000, secured by $2,056,000 principal amount of the Railroad Company's 5½% Series C First and Refunding Mortgage Gold Bonds, maturing April 1, 1956, with semi-annual interest coupons maturing subsequent to April 1, 1932 attached thereto.

To: Central Republic Trust Company its note dated April 1, 1932 for $545,980.58, secured by $666,000 principal amount of its above mentioned Series C bonds with semi-annual interest coupons maturing subsequent to April 1, 1932 attached.

(Central Republic Trust Company assigned its note together with the collateral to Reconstruction Finance Corporation.)

To: Commonwealth Subsidiary Corporation its note dated April 1, 1932 for $300,000 secured by $333,000 principal amount of its 6% Series A and its 5½% Series B First and Refunding Mortgage Gold Bonds, maturing January 1, 1955 and April 1, 1956, respectively, with all semi-annual interest coupons maturing subsequent to June 30, 1932 attached.

To: Public Service Subsidiary Corporation its note dated April 1, 1932 for $300,000 secured by $333,000 principal amount of its above mentioned Series A and Series B bonds with all semi-annual interest coupons maturing subsequent to June 30, 1932 attached.

Shortly thereafter, the Railroad was placed under an equity receivership. In 1942, the receivership proceeding was succeeded by a proceeding under Chapter X of the Bankruptcy Act. In 1943 and 1944, the bankruptcy court

authorized the sale of the Railroad's bonds which secured the 1932 notes.

In December, 1943, $10,800 face amount of Series A Bonds and $77,200 face amount of Series B Bonds were sold for $20,240. In January, 1944, $45,000 principal amount of Series A Bonds were sold for $10,350. In June, 1944, the bankruptcy court gave one of the creditors full ownership of $200,000 face amount of Series A Bonds in extinction of all rights under the collateral notes which the bonds had previously secured. In January, 1944, $300,000 face amount of Series A Bonds and $33,000 of Series B Bonds were sold for $90,576.

Finally, in June, 1944, Reconstruction Finance Corporation petitioned the bankruptcy court for leave to sell the collateral (the bonds) which secured the promissory notes issued either directly to it or to Central Republic Trust Company and subsequently assigned to the R.F.C. The R.F.C. was authorized to sell $2,722,000 of face amount of Series C Bonds with coupons attached for $29 per $100 face value of the bonds. The sales of the collateral held by the R.F.C. were consummated in July, 1944. The proceeds, $900,000, were paid to the R.F.C. The trustee reported that the R.F.C. applied the proceeds to reduce interest accrued on the notes it held.

In April, 1946, a plan of reorganization of the Railroad was approved. The plan was put into effect and thereby a new company, the Railway, was formed. The assets of the Railroad were transferred to the Railway free of all liens and encumbrances, with certain exceptions such as an obligation by the Railway to pay taxes due the United States. With respect to the Railroad's obligations, the plan provided:

> (1) For each $1,000 principal amount of First and Refunding Mortgage Gold Bonds, Series A, the Railway would issue 27.946 shares of common stock of the Railway and pay $195.62 in cash.

(2) For each $1,000 principal amount of First and Refunding Mortgage Gold Bonds, Series B, the Railway would issue 27,116 shares of common stock of the new company and pay $189.83 in cash.

(3) For each $1,000 principal amount of First and Refunding Mortgage Bonds, Series C, the Railway would issue 27,116 shares of common stock of the new company and pay $189.83 in cash.

(4) All of the claims of unsecured creditors were declared to be without value and not entitled to participate in the plan.

The Railroad used an accrual method of accounting; accordingly, annual deductions representing interest on the 1932 notes were taken on its federal income tax returns for the years 1932 through 1946, although such interest was never paid.

In its income tax return for 1944, the Railroad claimed a deduction as a result of the sale of the collateral (the bonds) in the amount of $4,185,029.07 (which it later reduced by $125,102.50 for bonds sold during the year 1943). The Railroad computed its deduction for 1944 as follows: It determined that $3,388,000 face amount of its bonds had been sold and that there had accrued $2,295,205.07 of unpaid bond interest, for a total amount of $5,683,205.07; that the bonds (with interest coupons attached) had been sold for $1,021,166, and that $477,010 of the Railroad's liabilities on a note had been extinguished for a total amount of $1,498,176, leaving a net balance (loss) of $4,185,029.07.

In its 1945 income tax return, the Railroad claimed a net operating loss deduction of $3,279,383.55 carried over from 1944. The district director of Internal Revenue disallowed the claimed deduction. Following negotiations and conferences, he assessed an additional income tax for 1945 in the amount of $144,208.59. The basis for this determina-

tion was an allowance of one-half of the amount claimed as a deduction for the year 1944.

In January, 1953, the Railway paid the additional assessment together with interest thereon amounting to $54,068.34, or a total of $198,276.93. It filed a claim for refund. The claim was rejected and the instant suit was filed in 1957. The case was tried in 1962 and the judgment of dismissal was entered in February, 1963.

I.

The Railway poses as the primary issue its contention that the net increase in liabilities ($4,185,029.07), sustained by the Railroad because of the sale of the collateral (the bonds) in 1943 and 1944, must be treated as an additional cost of the 1932 financing arrangement, and therefore, fully accruable and deductible as a business expense in 1944. The district judge in rejecting the Railway's contention held that the "loss [the difference between the bonds sold in 1944 plus twelve years of accrued coupon interest and the purchase price received] is to be viewed as traditional bond discount which under applicable principles and regulations of the Internal Revenue Code must be amortized over the life of the bonds."

The Railway argues that when the bonds were sold in 1944 all events had occurred to determine the exact amount of the Railroad's net additional liabilities resulting from its 1932 refinancing and its unconditional obligation to pay this amount. It says that the noteholders' disposal of the Railroad's bonds in 1944 must be treated as if it were a sale of collateral which was deposited in 1932 as security for its notes issued at that time. In other words, it contends that had the notes been paid when due in 1935, the bonds would have been returned to the Railroad and cancelled; but since the notes were not paid, the sale of bonds in 1944 resulted in an expense of $4,185,029.07 (the difference between the face amount of the bonds plus accrued

interest and the sale price) which accrued as a fixed obligation at the time the bonds were sold.

To put the Railway's position even more in focus, we quote from its brief:

> In the present case it is obvious that the sale of the collateral bonds in 1944 was the last step in the integrated borrowing transaction which had its inception in 1932 when the promissory notes were issued and the bonds themselves were deposited as security therefor. It was in the earlier year 1932 that the railroad company first incurred the risk that the collateral might ultimately have to be sold by its creditors at a substantial financial loss to itself—sale transactions that were eventually to establish the amount and fix the certainty of its loss beyond any possibility of recoupment and with no additional funds being made available for corporate purposes. It is therefore clear that the financial detriment suffered by the taxpayer in 1944 was *not* sustained in a separate and independent *funding operation* occurring in that year (*i.e.* in 1944), but directly and proximately resulted from a true funding operation undertaken by the taxpayer in 1932. In those circumstances the net additional liabilities accruing in 1944 necessarily represented an additional cost or expense of the loans obtained in the earlier year.

The answer to the Railway's contention must begin in actualities. First, the Railroad suffered no out-of-pocket loss or expense in 1944 as a result of the bond sale. Second, assuming that both the notes and bonds had eventually been paid by the Railroad sometime after 1944, the additional obligation representing the difference between the face amount of the bonds and the amount they were sold for would not have actually been paid until the bonds and coupons were retired and paid. There was no obligation to

pay the bonds during the year 1944; therefore, there was no accrual of this additional "obligation" in that year.

To state the situation in different language, the sale of the bonds must be viewed for tax purposes as an issuance by the Railroad of its bonds at less than their face value. It is settled law that a taxpayer who is on an accrual basis may not deduct the difference between the face amount of the debt incurred and the amount received in the year it issues bonds. *Helvering v. Union Pacific R. R.*, 293 U. S. 282 (1934); *Old Mission Co. v. Helvering*, 293 U. S. 289 (1934), although the amount of the discount may be amortized as a deductible item over the period between the date of sale and the maturity date. *Old Mission, supra*; *Treasury Regulation* 111 (1939 Code), Section 29.22(a)-17.

We believe the district judge correctly rejected the Railway's contention by adopting the view that the 1944 transactions constituted a sale of the Railroad's bonds at a discount.

Even this view, although theoretically and legally correct, overlooks a reality that makes the Railway's position even more untenable than it appears. The Railroad was insolvent and in bankruptcy in 1944 when the bonds were sold. On the basis of this known fact, it was a certainty that the Railroad could not pay the principal or interest of the bonds. Accordingly, the Railroad did not meet even the primary assumption of the bond discount rule, namely, that an absolute liability to pay the face amount of the principal and interest of bonds at maturity is created at the time of their issuance. Only legalistic make-believe permits us to say that the Railroad became "obligated" in 1944 to pay the face amount of bonds and interest coupons at their maturity.

The Railway argues that the bond discount rule applies only to a new funding operations, that is, where new capital is supplied, citing *Montana Power Co. v. United States*, 232 F. 2d 541 (3d Cir. 1956), *cert. denied*, 352 U. S. 843

(1956), and that the 1944 transactions were not of that character. But, the bonds in the instant situation were not issued until 1944. They were held in deposit from 1932 until 1944 as security for the notes and, hence, did not constitute an outstanding indebtedness during that period. Therefore, as a matter of law they must be treated as a new funding transaction in 1944.

II.

The Railway contends that if the Railroad was not entitled to a deduction in 1944 for the full amount of the difference between face amount of the bonds plus accrued interest and the amount received ($4,185,029.07), there are two alternative grounds for the requested refund. The first alternative issue, the Railway presents, is that it is entitled to deduct under Section 23(b) of the 1939 Code, 26 U.S.C. 1952 ed. § 23,[1] $2,295,205.07, representing the amount of interest coupons attached to the bonds for the period from 1932 to the date of sale in 1944. It argues that "*even though* the 1944 collateral bond sales be considered as a new and independent funding operation . . . still the matured interest obligation becoming due and payable in 1944 was deductible as a separate accrued item, and could not be amortized over the period remaining to the due date of the principal obligation."

The district judge ruled contrary and held "that the amount, representing 12 years coupon interest . . . should be treated as a part of the principal amount of these bonds or as an additional cost and expense of issuing the bonds, and in either event, should be amortized over the same period as the bond discount."

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[1] Section 23(b) of the 1939 Code provides in part as follows:

In computing net income there shall be allowed as deductions:

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness.

The Supreme Court in *Deputy* v. *du Pont*, 308 U. S. 488, 498 (1940), defined interest as "compensation for the use or forbearance of money"; and in *Old Colony R.R.* v. *Commissioner*, 284 U. S. 552, 560 (1932), the Court said, "And as respects 'interest,' the usual import of the term is the amount which one has contracted to pay for the use of borrowed money."

With these definitions in mind, it is apparent that the $2,295,205.07 which the Railway seeks to deduct as interest is not interest *in fact*. From 1932 to 1944 the Railroad deducted $1,591,523.23 of interest accruing on the promissory notes which were secured by the bonds and between 1944 and 1946 it continued to deduct $324,313.27 of interest on the notes. There was only one sum of borrowed money—that represented by the promissory notes—and the Railroad was allowed to deduct the accrued interest on this sum even though no interest was ever paid.

During the time the bonds were on deposit as security for the notes, there was no outstanding indebtedness against the Railroad that was represented by the bonds. The noteholders could not have collected both the interest represented by the coupons and by the notes. They were not entitled to double interest. By the same token, the Railroad was not entitled to a double deduction for income tax purposes.

This analysis still leaves us facing the fact that when the collateral bonds, due and payable in 1955 and 1956, were sold in 1944 there were coupons attached which on their face represented unpaid interest on the bonds from 1932 to the date of sale. If this were a true interest indebtedness, it would be difficult to say that it did not accrue in 1944, because the predated interest coupons matured and became due and payable forthwith upon the sale of the bonds. However, we have already demonstrated that the bonds did not represent any outstanding indebtedness against the Railroad while they were on deposit as security,

and, therefore, that the interest coupons for that period did not represent compensation for the use of borrowed money. But since these coupons did represent an indebtedness of the Railroad *after* the sale of the bonds, how should they be treated for income tax purposes? We are of the opinion that they must be viewed as an addition to and a part of the principal amount of the bonds, that is, as an additional security for the notes. The purchase price for the bonds included both the principal of the bonds and the coupons accrued and unpaid. That these coupons were denominated interest should not blind us from the fact that they did not represent compensation for the use of borrowed money; rather, they were additional security with the bonds for the payment of the notes. To conclude otherwise would be to ignore practical realities.

Having reached this conclusion, we are satisfied that the district judge was correct in holding that the Railroad was entitled to deduct only a *pro rata* portion of the accrued coupons in the same manner as the bond discount. While this could mean that the *pro rata* discount on the accrued and unpaid coupons might have extended over the remaining life of the bonds, on the other hand, had the coupons been paid at an earlier date, the Railroad would have been entitled to a *pro rata* deduction adjusted to the shorter period.

III.

As the second alternative issue, plaintiff contends that the Railroad was and, hence, it is entitled to a deduction in 1946 (rather than 1944) of the unamortized balance of the discount on the bonds and coupons when the bonds were exchanged for stock and cash and the property underlying the security was transferred to the new company.[2]

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[2] The plan of reorganization provided that all the assets of the Railroad be transferred to a new company, the Railway, free and clear of liens (with certain limited exceptions, such as federal taxes). The new company distributed its stock and cash to the holders of the Railroad's bonds.

Ordinarily, where a corporation issues bonds or a mortgage and the property which is burdened by the secured indebtedness is transferred to a third party who assumes the indebtedness, any existing expenses or discount relating to the security financing and which is being amortized by the corporation is accelerated and the original debtor is allowed a deduction of the unamortized amount. *Longview Hilton Hotel Co.*, 9 T.C. 180 (1947); *S. & L. Building Corp. v. Commissioner*, 19 B.T.A. 788, 795 (1930); *Metropolitan Properties Corp. v. Commissioner*, 24 B.T.A. 220, 225 (1931); *Anover Realty Corp.*, 33 T.C. 671, 674 (1960). In accordance with these cases, the Railway argues that it became entitled to the unamortized discount because of the transfer of the bond-encumbered property to it in complete liquidation and dissolution of the Railroad.

In the usual situation, the cases which plaintiff relies upon would apply. But the present case is not of that character. The Railroad was insolvent in 1946. It paid neither interest nor principal on the bonds upon their cancellation. The corporation was dissolved and liquidated. The new company, the Railway, not only issued its stock and cash in exchange for the bonds and coupons, but it became obligated to pay the federal taxes of its predecessor in interest. By virtue of these facts, the Railway is, in reality, the one who seeks to take advantage of the deduction which it contends was available to the Railroad.

Either of two reasons precludes the granting of the refund on the basis that the unamortized balance of the discount was available as a deduction.

First, looking through form to substance, the new company was actually a continuation of the Railroad and under the rationale of *Chicago R.I. & P. Ry. v. Commissioner*, 47 F. 2d 990 (7th Cir. 1931), *cert. denied*, 284 U. S. 618 (1931), the unamortized discount may not be deducted. In that case this court held that unamortized discount on debenture bonds of a railroad at the time the bonds were exchanged

for preferred stock of the same par value was not a loss deductible from income; that it was "purely a capital transaction, which did not result in a deductible loss."

We agree with the Government's contention that in accordance with *Chicago R.I. & P. Ry.* if the old corporation were reorganized, no deduction would be allowed. Therefore, there is no reason why a deduction should be allowed the old corporation because a new corporation was formed which issued stock and cash pursuant to a chapter X reorganization. The successor corporation is substantially the same as the old corporation and it carried on the identical business. The old company is not entitled to a deduction which it could not have taken if the reorganization had been effected without the use of the new company.

Second, even considering the situation from a formalistic standpoint (as plaintiff insists) that there were separate entities, namely, an old company which was dissolved and liquidated and a new company which had a different capital structure and different shareholders, the Railway is not entitled to take advantage of any deduction available to its predecessor based on the unamortized bond discount.

An analogous situation existed in *Anover Realty Corp., supra.* In that case, it was held that a new corporation was not entitled to the unamortized portion of the discount of certain mortgage expenses which was being amortized by a different corporation that had issued the mortgage and had been dissolved. The different entity theory advanced by plaintiff is dichotomous. In order to maintain that the Railroad was entitled under the authorities it cites to an accelerated discount upon its dissolution, plaintiff says that there was no identity between the old and the new companies. Yet, these cases are authority for the proposition that the new company may not take the deduction—that it was available only to the old company.

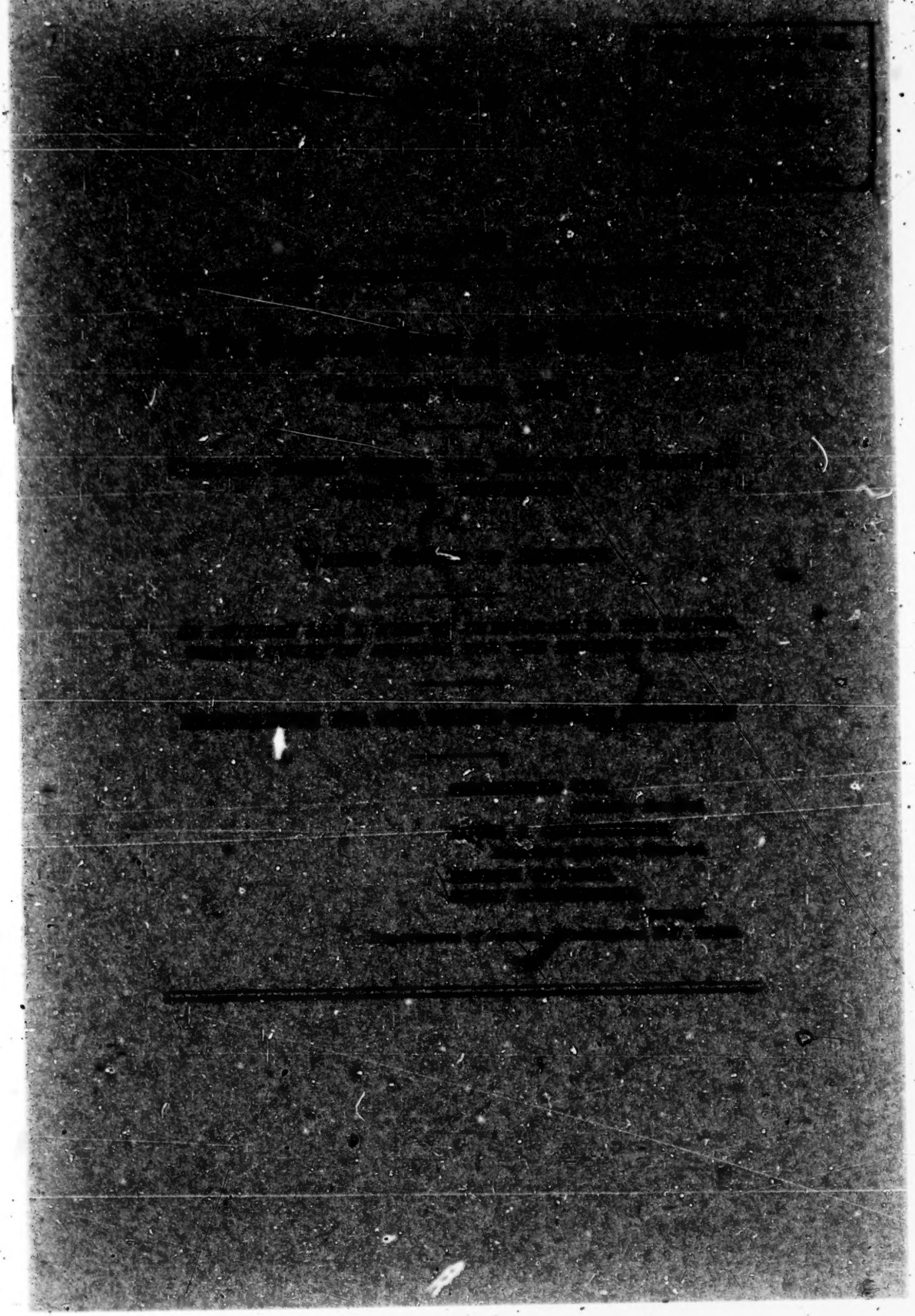
The judgment is affirmed.

Judgment

January 16, 1964

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Illinois, Eastern Division, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the judgment of the said District Court in this cause appealed from be, and then same is hereby, AFFIRMED, in accordance with the opinion of this Court filed this day



In the Supreme Court of the United States

OCTOBER TERM, 1963

No. 983

CHICAGO NORTH SHORE AND MILWAUKEE RAILWAY COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

The undisputed facts of this case are set forth in the opinion of the court below (Pet. App. 1a–5a). Briefly stated, an interurban railroad, hereafter referred to as the taxpayer, in 1932 borrowed $2,295,980.58 on four promissory notes due April 1, 1935, bearing interest at 6 percent. The loan was secured by a pledge of its unissued 5½ and 6 percent series mortgage bonds maturing January 1, 1955, and April 1, 1956, in the face amounts of $3,388,000, with semi-annual interest coupons attached (Pet. App. 2a). Shortly after the loans were made, the taxpayer was placed under an equity receivership which was succeeded in 1942 by a Chapter X bankruptcy proceeding.

732-018—64

In 1943 and 1944 the bankruptcy court authorized a sale of the pledged bonds with the interest coupons attached, on which there had accrued unpaid interest of $2,295,205.07. Although having a total face value of $5,685,205.07 (including accrued interest) the bonds were sold for only $1,021,166. The proceeds were paid to the noteholders, being applied $477,010 to principal and the rest to accrued interest due on the notes (Pet. App. 4a). In April 1946, a plan of reorganization of the taxpayer was approved and put into effect, whereby all the unsecured debts were wiped out and its assets were transferred to a new railway company, free of all liens and encumbrances but subject to taxes due the United States by the taxpayer. The plan of reorganization provided that the new company would pay to the bondholders, for each $1,000 bond, approximately $190 in cash plus 27 shares of its common stock.

This case involves a suit for refund by the reorganized company, which, as transferee, had paid income tax deficiencies asserted against the taxpayer. The taxpayer makes three principal claims. First, it argues (Pet. 19–22) that the increase in its liabilities resulting from the sale of the bonds in 1943 and 1944 ($4,185,029.07) constituted an additional cost of the 1932 financing and therefore was fully deductible as a business expense in 1944. Second, the taxpayer contends (Pet. 7–13) that, if it is not entitled to the entire $4,185,029.07 deduction, it can still deduct in 1944 the amount of interest coupons attached to the bonds representing interest from 1932 to 1944 ($2,295,205.07). And finally, the taxpayer claims (Pet. 15–18) that, if it is wrong on its other arguments, it is entitled to amortize the discount

on the bonds and attached interest coupons, and that the entire unamortized balance is deductible in 1946 when the bonds were exchanged for stock and cash and the property underlying the bonds was transferred to the new company. These claims were rejected by the district court, except that it allowed the taxpayer to deduct in 1944 and 1945 as bond discount the amortized amount of the difference between the face amount of the bonds plus accrued interest and their 1944 sales price, spread over the remaining term of the bonds of eleven to twelve years. The court of appeals affirmed the decision (326 F. 2d 860; Pet. App. 1a–12a).

The decision of the court below was plainly correct on its face. The 1944 sale of the bonds was at a discount which the taxpayer could amortize. However, even this deduction was more than the taxpayer was entitled to claim, since a bond discount assumes that the taxpayer has actually incurred a debt in excess of the price received for its bonds. Here, as the court below stated (Pet. App. 7a):

> Even this view, although theoretically and legally correct, overlooks a reality that makes the Railway's position even more untenable than it appears. The Railroad was insolven[t] and in bankruptcy in 1944 when the bonds were sold. On the basis of this known fact, it was a certainty that the Railroad could not pay the principal or interest of the bonds. Accordingly, the Railroad did not meet even the primary assumption of the bond discount rule, namely, that an absolute liability to pay the face amount of the principal and interest of bonds at maturity is created at the time of the r issuance. Only legalistic make-believe

permits us to say that the Railroad became "obligated" in 1944 to pay the face amount of bonds and interest coupons at their maturity.

Similarly, as the court of appeals held, the accrued interest up to 1944 on the bonds did not represent interest on any outstanding indebtedness, but instead in reality arose at the time the bonds were sold and constituted "a part of the principal amount of the bonds" which should be amortized like the bond discount (Pet. App. 10a). As to the taxpayer's last contention, the extinguishment of the bonded debt in the reorganization was for approximately the sales price of the bonds. Since the taxpayer was thereby relieved of the obligation which the bond discount represented, the taxpayer is not entitled to any further amortization of the discount let alone accelerated amortization.

In short, the taxpayer's contentions all lack reality. None of the cases relied on by it involved situations in any way like the unusual circumstances involved here. There is no conflict or any other reason for review of the decision by this Court.

The taxpayer also contends (Pet. 13–15) that it was entitled to continue to deduct interest on the remaining outstanding promissory notes after the sale of the bonds in 1944 and up to the reorganization, even though, as it admits, "there was little likelihood that the notes or the interest thereon would be paid" (Pet. 3). The lack of reality of the purported obligation to pay interest fully justified the decision below denying the deduction. The cases cited by the taxpayer as being in conflict are not in point, since the facts in each were that the debt and the interest incurred or paid were genuine.

For the foregoing reasons, we respectfully submit that the petition for a writ of certiorari should be denied.

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MAY 1964.

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No. 983

IN THE

Supreme Court of the United States

OCTOBER TERM, 1963

CHICAGO, NORTH SHORE AND MILWAUKEE RAILWAY COMPANY, *Petitioner*,

v.

UNITED STATES OF AMERICA, *Respondent*.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1963

No. 983

CHICAGO NORTH SHORE AND MILWAUKEE RAILWAY COMPANY, *Petitioner*,

v.

UNITED STATES OF AMERICA, *Respondent*.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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PETITIONER'S REPLY

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1. The respondent's Memorandum in Opposition does not even mention the first reason for granting the writ set forth in the Petition. The interest accrued from January 1, 1944, to the respective dates of the sale of the collateral bonds in 1944, was $81,392.82. This amount which was stipulated to be interest was not allowed as a deduction by either the trial court or the Court of Appeals. The failure to allow such de-

duction is clearly in conflict with the three Court of Appeals cases cited at page 8 of the Petition, one of which cases was affirmed per curiam by the Supreme Court.

The respondent's failure to meet this point is an obvious admission of its merits.

2. Respondent states that the increase in liabilities resulting from the sale of the bonds in 1944, approximately $4,185,029.07, was not accruable and deductible in 1944 because, contrary to petitioner's contention, it was not a cost of the 1932 financing arrangement.

Neither the respondent nor the Court of Appeals opinion fully states petitioner's contention.

Petitioner contends that the $4,185,029.07 was an obligation incurred in the regular course of business and is deductible in 1944 when it accrued unconditionally. *United States* v. *Consolidated Edison Co.*, 1961, 366 U.S. 380, 384, 81 S. Ct. 1326, 1329, supports this contention.

Whether the amount be designated as a cost of the 1932 financing arrangement or whether it is called wholly principal, or partly principal and partly interest or by some other name is immaterial. It was an obligation incurred in the normal course of business and is deductible as an ordinary and necessary business expense. Cf. *Commissioner* v. *Heininger*, 1943, 320 U.S. 467, 471, 64 S. Ct. 249, 252.

The failure to allow the deduction is in conflict with the *Consolidated Edison Co.* case, *supra*, and the cases cited therein.

3. Both courts below held that the $4,185,029.07 must be amortized as bond discount over the intervening

period to the original due date of the Series B and C Bonds in 1956 (ignoring the fact that the Series A bonds' original maturity date was January 1, 1955).

As pointed out at page 20 of the Petition, the bonds contained an acceleration provision that upon an adjudication in bankruptcy or upon appointment of a receiver, the principal of all of the bonds "*shall thereupon become due and payable*". Paragraph 1 of the Stipulation of Facts shows the appointment of receivers and subsequent bankruptcy proceedings, prior to the sale of the collateral bonds in 1944.

The collateral bonds, therefore, matured and became due and payable forthwith upon their sale in 1944. They were, in effect, demand obligations. *There was no future maturity date to which the $4,185,029.07 could be amortized.*

This was pointed out at pages 20-21 of the Petition. The petition also states, at page 12:

> "There is no statutory provision, no regulation, and so far as we are aware no court decision, other than the present one, which requires the amortization of bond discount beyond the date when such obligation matures and becomes due and payable."

The respondent did not choose to even mention the foregoing in its Memorandum in Opposition, thus in effect conceding, as we think it must, the correctness thereof. It cites no cases, regulations or rulings to the contrary.

The decision of the courts below requiring amortization beyond the accelerated maturity date when the $4,185,029.07 became due and payable upon the sale of the collateral bonds in 1944, is in conflict with the

rationale of *Helvering* v. *Union Pacific R. Co.*, 1934, 293 U.S. 282, 284, 286, 55 S. Ct. 165, 166-168, and all other bond discount cases, and is in conflict with the "all events" rule of accrual deduction reaffirmed in *United States* v. *Consolidated Edison Co.*, 1961, 366 U.S. 380, 81 S. Ct. 1326.

4. The Memorandum in Opposition defends the disallowance of accrued interest on the three promissory notes, (two held by Reconstruction Finance Corporation and the other held by a bank) upon the ground that the obligation to pay interest lacked reality. It did not attempt to reconcile the present case with the Court of Appeals cases and the Supreme Court case cited at page 14 of the Petition, except to say that, in the cited cases, the obligations were genuine.

The note obligations in the present case were genuine obligations allowed as claims in the bankruptcy proceeding.

On this point the present case is in direct conflict with the three Fifth and Eight Circuit cases cited on page 14 of the Petition.

5. The major thrust of the contention made in the Memorandum in Opposition is that the collateral bond obligations were not genuine obligations because the obligor was insolvent, and hence, the obligations lacked reality. And it quotes from the Court of Appeals opinion to the effect that there was no "absolute liability" to pay the same.

Such argument confuses the issue. There was a genuine unconditional legal liability to pay the collateral bond obligation in full immediately upon the sale thereof in 1944. There was some twelve million

dollars, face amount Series A, B and C bonds outstanding *in addition* to three and one-half million face value of the collateral bonds. The claims of the collateral bonds purchasers were fully allowed in the Chapter X proceeding both as to principal and past accrued interest as real and genuine claims. They were allowed both as to principal and interest, to the same extent, and exactly the same manner and amount as the claims of the other bondholders, who held the balance of the outstanding issue. And all of these bonds were paid off by the successor corporation by the payment of cash and an issue of the latter's common stock, the new corporation having a net worth of over twenty million dollars as shown by its balance sheet.

They were genuine obligations and were paid in full.

6. The Memorandum in Opposition is most unusual in that it does not cite a single case, it does not discuss any of the cases cited in the Petition, nor does it point out how or why the cases cited in the Petition are not in conflict with the present case. It merely states that the cited cases are not in point.

The Memorandum in Opposition is, in substance a confession and advoidance, with, we suggest, very little of the latter. Petitioner respectfully submits that the Petition should be granted.

Respectfully submitted,

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